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Supreme Court of the United States

OCTOBER TERM, 1942

No. 239

JAMES A. RHEINSTROM, EXECUTOR UNDER THE WILL OF MINNA W. RHEINSTROM, DECEASED, PETITIONER,

v.

THOMAS J. CONNER, COLLECTOR OF INTERNAL REVENUE.

No. 240

FIRST NATIONAL BANK, CINCINNATI, OHIO, TRUSTEE UNDER THE WILL OF KARL KIEFER, DECEASED, PETITIONER,

v.

THOMAS J. CONNER, COLLECTOR OF INTERNAL REVENUE.

On Petition for Writs of Certiorari to the United States Circuit Court of Appeals for the Sixth Circuit

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REPLY BRIEF OF PETITIONERS IN SUPPORT

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1. The example quoted on pages 7-8 of Respondent's brief is not apposite under the facts here, because the cancellation here occurred in 1914, long before the earnings accumulated, and therefore could not have been made with any thought to use it as a device to distribute earnings.

2. It does not meet petitioners' Reason I (Pet. 9-11) to say that an appellate court may sustain a decision of a lower tribunal on a different theory (Resp. Br. 8). The

Court below went much farther than that. It decided the cases on an issue raised *sua sponte* by it, although never urged or mentioned at any time by either side or by the trial court, and the petitioners, therefore, never had an opportunity to meet it, or to present evidence in refutation thereof. The very cases cited by the respondent bear out this distinction. In *LeTulle* v. *Scofield*, 308 U. S. 415, the Court allowed certiorari on this very ground. It did not have to pass upon it on the merits, however, as the decision appealed from was found to be correct on other grounds. In *Helvering* v. *Gowran*, 302 U. S. 238, 245, where the Court permitted the Government to urge a new theory, it was very careful to permit the taxpayer to reopen the case before the Board of Tax Appeals to present any additional facts which might affect the result. It is clear from these decisions and from the decisions cited in the Petition for certiorari, that this Court has always been careful to protect a litigant's right to his day in court.

Respondent admits that the question of whether a distribution was "essentially equivalent to the distribution of a taxable dividend" is one of fact (Resp. Br. 9). It is idle to say that the Circuit Court of Appeals did not make such a finding. The Circuit Court of Appeals necessarily made such a finding by its conclusion. To make a finding, no court has to say "We hereby find." Where a conclusion is in effect a finding, it is none the less a finding even though it may not be expressly described as such by the court. It is clear from reading the District Court's findings and conclusions that it had no thought of Section 115 (g). It was erroneously of the opinion that to have a partial liquidation under Section 115 (i), a closing out or contraction of the business was necessary (R. 63-4), and found that the distribution in question was therefore conclusively presumed to be dividends from earnings under paragraphs (a) and (b) of Section 115. Nor is it correct

to say (Resp. Br. 10) that the findings of the District Court require the conclusion that the distribution was "essentially equivalent to the distribution of a taxable dividend," and that therefore the Circuit Court of Appeals was justified in so concluding. The primary facts as found by the Court of Claims in *Foster* v. *United States,* 303 U. S. 118 (see 17 Fed. Supp. 191, 192), are quite similar to those in the cases at bar. Yet this Court affirmed the conclusion that a partial liquidation had taken place. It would have been the function of the District Court to make the finding of ultimate fact as to whether or not the cancellation and distribution in question were essentially equivalent to the distribution of a taxable dividend, if that had been an issue in the case, but not having so found, it was not within the province of the Circuit Court of Appeals to usurp that function.

3. Respondent's effort (Resp. Br. 10-11) to avoid the conflict in the Circuits referred to under petitioners' Reason II (Pet. 11-13) is unsound. The factual distinctions in the cases sought to be found by the respondent are irrelevant or nonexistent. The point of the conflict was the question of the materiality of motive in the applicability of Section 115 (g). The contention of respondent that a distribution in partial liquidation exempted from Section 115 (g) cannot exist when there are uncapitalized earnings present, is contrary to the decision of *Foster* v. *U. S.*, 303 U. S. 118, where there was a large earned surplus existing at the time the stock involved there was cancelled.

4. The decision of the courts below on the question of partial liquidation was not mere dicta (Resp. Br. 11). The District Court's judgments were based on that court's erroneous conception of the necessary requirements of partial liquidation under Section 115 (i) (R. 63-4), and

the Circuit Court of Appeals affirmed that holding (R. 104-5).

5. The respondent is in error in arguing (Br. 12) that the prohibition against retroactivity on the application of Section 115 (g) affects *distribution only*. Section 115 (g) provides:

> "If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution *and cancellation* or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend . . ." (Emphasis ours.)

This shows that the time and manner of the *cancellation* is equally as important as the *distribution* in determining taxability.

Congress, in broadening Section 115 (g) to cover stock not issued as a stock dividend specifically limited the application of Section 115 (g) to such stock, to cases where *"the cancellation or redemption is made after January 1, 1926."* (See Pet. 13-14 and notes; also Resp. Br. 12, note.) The prohibition thus specifically covers cases of cancellation without respect to when the distribution is made. The cancellation was complete in 1914, and must have been, because the shares were turned in and the authorized capital was reduced at that time, and the company thereby became obligated to make the distribution. Congress, by the language it employed, showed that it considered the *cancellation as something separate* from the distribution, and that Section 115 (g) was to be applicable *only if the cancellation occurred after January 1, 1926.*

6. Respondent's contention (Br. 12-13) that even if the distribution in 1934 was in payment of a debt due the stockholders by reason of the reduction of capital and cancellation of the stock, that would not affect the appli-

cation of Section 115 (g), is not understandable. Payment of a real debt and a distribution under Section 115 (g) are necessarily mutually exclusive. If the cancellation were a tax evasion device, no real debt would be created. That is an additional reason why the exclusion of the proffered evidence to show the existence of this debt in fact as well as in law, was prejudicially erroneous. In the seven years that this matter has been in controversy, the Government has not been able to suggest any reason that the stockholders might have had for the reduction in capital and the cancellation of the 1220 shares other than that sought to be shown by the proffered testimony.

7. Respondent's discussion (Br. 13) of the resultant *nunc pro tunc* gift of $36,600 to Karl Kiefer forced upon Mrs. Rheinstrom by the decisions below, misses the point entirely. Petitioners' purpose in showing that such a gift would be forced upon Mrs. Rheinstrom by the decisions below, was to prove that a very real change did take place in the proportionate ownership of the corporation by the cancellation of the 1220 shares of common stock, and to demonstrate that the explanation given by the proffered testimony for the reduction in capital was not only credible but necessarily correct, as it would be inconceivable to suppose that one stockholder, for no reason at all, would make a gift worth at least $36,600 to another, of a one-fifth interest in the ultimate ownership of a corporation. While it is true that Mrs. Rheinstrom received one-half of the $122,000 distribution, made in 1934, if the respondent prevails, this will have to be charged against the earnings of the corporation, and the surplus created by the reduction in capital will be distributable upon final liquidation, at which time the Kiefer heirs, by reason of their preferred stock holdings, will receive $36,600 of Mrs. Rheinstrom's share. (See Pet. 17-18.)

8. Respondent (Br. 13-14) also misses the point of petitioners' Reason VII (Pet. 20-21). Petitioners concede that capital gains or unusual dividends, involved in the cases cited by respondent, may be subject to income taxes in the hands of a trustee, even though considered principal under the trust. In the cases at bar, however, if the distribution was not a return of capital, but dividends from earnings, then the life tenant was entitled to receive the same under the trust, and she, and not the trustee, should pay the tax thereon. The distribution was either a return of capital or it was not. If it was, it is not taxable at all; if it was not, the life tenant, not the trustee, should pay the tax.

CONCLUSION

For the reasons stated in the petition, it is respectfully prayed that the writs issue.

Respectfully submited,

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